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Supreme Court of the United States

October Term, 1979

No. 79-1149

ALLSTATE SAVINGS AND LOAN ASSOCIATION, Successor-in-Interest to Metropolitan Savings and Loan Association of Los Angeles,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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No. .....

ALLSTATE SAVINGS AND LOAN ASSOCIATION, Successor-in-Interest to Metropolitan Savings and Loan Association of Los Angeles,

Petitioner,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

I

PETITION FOR WRIT OF CERTIORARI.

Petitioner Allstate Savings and Loan Association, successor-in-interest to Metropolitan Savings and Loan Association of Los Angeles ("Metropolitan"), hereby petitions that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on July 13, 1979.

II

CITATION TO OPINIONS BELOW.

The opinion of the Court of Appeals for the Ninth Circuit with respect to which review by certiorari is sought herein affirmed a decision of a single judge of the Tax Court. The Ninth Circuit's opinion (Appen-

dix ["App."] A) is reported at 600 F.2d 760 (9th Cir. 1979) and the Tax Court's opinion (App. B) is reported at 68 TC 310 (1977).

III
JURISDICTION.

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on July 13, 1979. On August 22, 1979, Petitioner, pursuant to an extention of time granted by the Ninth Circuit, duly and timely filed a Petition for a Rehearing In Banc which was denied on October 5, 1979 (App. C). By order dated December 10, 1979, Mr. Justice Rehnquist extended the time for filing a Petition for Writ of Certiorari herein to and including January 25, 1980. Jurisdiction of this Court is invoked under 28 USC §1254 (1).

IV
PRELIMINARY STATEMENT.

This is a major case of first impression which involves an exceptionally important issue of federal income tax law that will have an enormously significant and continuing economic impact on all of the nation's savings and loan associations, mutual savings banks (without capital stock) and cooperative banks (without capital stock). Moreover, this is the first litigated case involving the scope and meaning of Section 595 of the Internal Revenue Code of 1954, as amended ("IRC" or the "Code"), the principal statute involved in this controversy. As a consequence, this is the most far

reaching and important tax case affecting the nation's savings and loan and thrift industry since this Court, *by certiorari*,[1] decided *CIR v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971), *rev'g* 422 F.2d 90 (9th Cir. 1970).

Astonishingly, in this, the most important tax case affecting the savings and loan and thrift industry since the *Lincoln* case, the Ninth Circuit, by an unprecedented "non-opinion", has completely abdicated its appellate responsibility by letting stand, without expressing *any* independent analysis or reasoning, an egregiously "bad" and totally erroneous decision of one Tax Court judge which *overruled* explicit provisions of the controlling legislative regulations ("Regulations") of the Secretary of the Treasury ("Secretary") squarely on point.

Unless this Court reverses the decisions below, IRC §595 and the Secretary's Regulations thereunder *having the force and effect of law* will have been completely overriden by judicial fiat in a manner wholly inconsistent with the intent of Congress and in total derogation of the exercise by the Secretary of an expressly delegated legislative function.

This unwarranted infringement of the legislative and executive prerogative should be reason enough for reversal. But, there are other serious, substantive grounds for reversal; for both Courts below, in contravening the explicit provisions of IRC §595 and the Secretary's legislative Regulations thereunder, have rendered embar-

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[1] *CIR v. Lincoln Savings and Loan Association*, 400 U.S. 901 (1970).

rassingly ill-considered and palpably erroneous opinions which are totally bereft of thoughtful analysis and puerile in their comprehension of the fundamental issues involved in this case.

In seeking reversal of these patently "bad" decisions, Petitioner wishes to emphasize that we are *not* here dealing with "technical" and sophisticated tax questions which depend for their resolution upon any special tax expertise. Rather, the determination of the issues involved herein require a basic understanding of the nature of the savings and loan business (particularly the legal effect of the foreclosure process under applicable local law)—a matter with respect to which the Courts below possessed absolutely no understanding, let alone expertise—as well as the application of venerable principles of statutory construction and elementary concepts of income taxation (not to mention logic and just plain common sense)—*all of which were either ignored or overlooked below.*

V
QUESTION PRESENTED.

The ultimate question presented by this appeal is whether certain post-foreclosure expenses incurred by Metropolitan in the ordinary course of its business as a savings and loan association in connection with the systematic disposition of properties previously acquired through foreclosure constitute deductible business expenses under IRC §162(a) or non-deductible charges to Metropolitan's bad debt reserves pursuant

to the provisions of IRC §595 and the Regulations thereunder. This ultimate question, in turn, depends upon the resolution of a more fundamental issue: namely, whether IRC §595 is the *exclusive* provision of the Code dealing with *all* federal income tax consequences of mortgage foreclosure and, therefore, *preempts* the application of IRC §162(a) to the post-foreclosure expenses in issue.[2]

It is not, and indeed cannot be, disputed that the post-foreclosure disposition expenses in issue were *not* required to be charged to Metropolitan's bad debt reserves prior to the enactment of IRC §595.[3] Nor is it disputed that if the post-foreclosure expenses in issue are not required to be charged to Metropolitan's bad debt reserves pursuant to the provisions of IRC §595, such post-foreclosure expenses are deductible under IRC §162(a).

Therefore, the threshold question involved in this appeal is plainly and simply whether IRC §595 *changed* the tax treatment of the post-foreclosure expenses in issue. If it did not, as the Regulations under IRC §595 expressly provide (Treas. Reg. §1.595-1(e)(7)), the decisions below, which so held, are wrong *per se* and must be reversed.

Incredibly, neither the Tax Court nor the Ninth Circuit addressed, much less analyzed, this determinative issue.

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[2]See pages 15-19 *infra.*

[3]See pages 19-23 *infra.*

VI

PRINCIPAL STATUTE AND REGULATIONS.

A. Statute and Regulations.

The principal statute and regulations involved herein are IRC §595 (App. D) and the Regulations thereunder (App. E).[4]

B. The Legal Force and Effect of the Secretary's Regulations Promulgated Under IRC §595.

It is extremely important to recognize that the Regulations promulgated by the Secretary under IRC §595 are *legislative* Regulations, as distinguished from *interpretive* Regulations, inasmuch as they were issued pursuant to the congressional directive set forth in IRC §595(d) which mandates that the Secretary "shall prescribe such regulations *as he may deem necessary to carry out the purposes* of this section." (App. D at 28) (Emphasis added).

Legislative Regulations have the force and effect of law and "[s]o long as they are confined within the limits of the statutory delegation, their force will be recognized by the courts even though the courts may consider them illiberal, inequitable or not conducive to the best results." *Seattle-First National Bank v. U.S.*, 44 F.Supp. 603, 607 (E.D. Wash. 1942);

[4]IRC §595 applies to certain aspects of mortgage foreclosures by all domestic building and loan associations, mutual savings banks not having capital stock represented by shares and cooperative banks without capital stock organized and operated for mutual purposes without profit. IRC §§593(a) and 595(a); Treas. Reg. §1.595-1(a). However, for convenience and ease of reference, the term "savings and loan association" will, unless the context otherwise requires, be used in this Petition to denominate the class of thrift institutions to which the provisions of IRC §595 apply.

see also *Utah Power & Light Co. v. U.S.*, 243 U.S. 389, 410 (1917).[5]

These principles apply to the Regulations of the Secretary promulgated under the Code, such as those promulgated under IRC §595, which are issued pursuant to congressional mandate to implement the underlying statute and therefore are necessary to make the same effective. *United States v. California Portland Cement Co.*, 413 F.2d 161, 164 (9th Cir. 1969).

Indeed, as this Court has held on numerous occasions, most recently in *Fulman v. U.S.*, 434 U.S. 528, 533 (1978):

> "'[I]t is fundamental . . . that as contemporaneous constructions by those charged with administration of' the Code, [Treasury] Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,' and 'should not be overruled except for weighty reasons.' Bingler v. Johnson, 394 US 741, 749-750, 22 L Ed 2d 695, 89 S Ct 1439 (1969), quoting Commissioner v. South Texas Lumber Co., 333 US 496, 501, 92 L Ed 831, 68 S Ct 695 (1948); accord, United States v. Correll, 389 US 299, 306-307, 19 L Ed 2d 537, 88 S Ct 445 (1967)."

The controlling force of the Secretary's Regulations under IRC §595 cannot be overemphasized in this case inasmuch as the decisions of both the Tax Court and the United States Court of Appeals for the Ninth Circuit, not to mention Rev. Rul. 73-116, 1973-1 CB 300 (App. H), which reflects Respondent's published

[5]See generally Davis, *Administrative Law Text*, §5.02 at 126 (3rd ed. 1972).

position on the issue in this case, all are *hopelessly* and *irreconcilably* in direct conflict therewith and therefore are contrary to law and cannot stand. *Cf. Manhattan General Equipment Co. v. CIR*, 267 U.S. 129, 134 (1930); *Dixon v. U.S.*, 381 U.S. 68, 74 (1965); see also *U.S. v. Eddy Bros., Inc.*, 291 F.2d 529, 531 (8th Cir. 1961).

VII
STATEMENT OF THE CASE.

A. Summary Statement of the Facts.

Briefly summarized below are the uncontroverted, stipulated facts of this case.

1. Metropolitan.

Metropolitan was organized as a savings and loan association under the laws of the State of California on or about June 16, 1936 and was, at all relevant times, duly qualified and licensed to, and did, conduct a savings and loan business in accordance with the provisions of the California Savings and Loan Law.

The savings and loan business conducted by Metropolitan during the period of its operations consisted principally of acquiring savings from the public and lending money, primarily upon the security of interests in real property ("security property").

2. The Foreclosure Process—in General.

From time to time during Metropolitan's operations, Metropolitan's borrowers defaulted in the payment of its real property loans. Under applicable California law, Metropolitan could not sue its borrowers to collect the defaulted real property loans without resorting to

foreclosure.[6] As a result, Metropolitan was required, from time to time, to foreclose upon defaulted real property loans and, therefore, acquired parcels of security property *through foreclosure.*

Acquiring security property through *foreclosure* is distinguishable from acquiring possession of security property prior to actual *foreclosure* because, under California law, the borrower's interest in the security property can only be extinguished by *foreclosure*—judicial[7] or non-judicial.[8] This distinction is vital because, until the interest of the borrower in the security property is extinguished by foreclosure, there can be "*accountability*" between a borrower and a lender for income received and expenses incurred with respect to such security property[9]—*the factor which is dispositive of the ultimate issue in this case.* Treas. Reg. §1.595-1(e)(7) and (8) (exs. 1 and 2).

3. Methods of Foreclosure—Judicial or Non-Judicial Foreclosure.

Under California law, foreclosure of security interests in real property can be effected either through judicial proceedings ("judicial foreclosure") or privately ("non-judicial foreclosure") by trustee's sale or voluntary conveyance.

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[6]See California Code of Civil Procedure §726. *Roseleaf Corp. v. Chierighino*, 59 Cal.2d 35, 38-39 (1963); *Brown v. Jensen*, 41 Cal.2d 193, 195 (1953).

[7]*See generally* Chapter 1 of Title 9 (particularly §§701-707), and Chapter 1 of Title 10 (particularly §725), of the California Civil Code.

[8]*See generally* Chapters 1 and 2 of Title 14 of Part 4 of Division 3 of the California Civil Code.

[9]*Compare, e.g.*, California Civil Code §2924c *with* California Code of Civil Procedure §726.

The essential distinction between judicial and non-judicial foreclosure under California law involves the borrower's right of redemption and, correlatively, the lender's right to obtain a deficiency judgment. If Metropolitan foreclosed upon a defaulted real property loan pursuant to non-judicial foreclosure, the interest of the borrower in the security property securing the defaulted real property loan so foreclosed upon was completely and finally terminated upon the consummation of such foreclosure;[10] thereafter, the borrower could not have redeemed the security property from Metropolitan and, concomitantly, Metropolitan could not have obtained a deficiency judgment from the borrower.[11]

However, if Metropolitan foreclosed upon a defaulted real property loan pursuant to judicial foreclosure, the interest of the borrower in the security property securing the defaulted real property loan foreclosed upon was not thereupon terminated. Instead, the borrower had a statutory right to redeem the security property within 3 to 12 months following the date of the judicial sale[12] and Metropolitan had a correlative right to seek a deficiency judgment against the borrower.[13]

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[10]*Smith v. Allen,* 68 Cal.2d 93, 96 (1968); *Hohn v. Riverside County Flood Control and Water Conservation Dist.*, 228 Cal. App.2d 605, 612 (1964).

[11]*Loretz v. Cal.-Coast Development Corp.*, 249 Cal.App. 2d 176, 178 (1967); *Roseleaf Corp. v. Chierighino, supra* at 43-44; *Union Bank v. Gradsky*, 265 Cal.App.2d 40, 43 (1968).

[12]*See* California Code of Civil Procedure §§701-707.

[13]*See* California Code of Civil Procedure §726.

All of the underlying defaulted real property loans involved here were foreclosed upon by Metropolitan pursuant to non-judicial foreclosure.

4. The Subject Expenses.

During the taxable years 1968 and 1969, Metropolitan, in the ordinary and normal course and conduct of its savings and loan business, sold various parcels of foreclosed security properties and paid post-foreclosure disposition expenses in connection therewith in the amounts of $223,546 and $37,764, respectively (the "subject expenses").[14] Metropolitan deducted the subject expenses as ordinary and necessary business expenses under IRC §162(a) on its federal income tax returns for the taxable years 1968 and 1969.

Since all of the parcels of foreclosed security property with respect to which the subject expenses were incurred were previously acquired by Metropolitan pursuant to non-judicial foreclosure, none of the borrowers under any of the defaulted real property loans for which these parcels of foreclosed security property were security was accountable to Metropolitan for any of the subject expenses and, consequently, none of the subject expenses were chargeable to such defaulted real property loans.

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[14]These subject expenses consisted primarily of real estate brokerage commissions.

B. Proceedings Below.

1. Certain Prior Administrative Proceedings.

During the audit of Metropolitan's 1968 and 1969 tax returns, the District Office of the Internal Revenue Service having audit jurisdiction over Metropolitan requested "technical advice" from the National Office of the Internal Revenue Service concerning the deductibility of the subject expenses.[15]

After more than nine months of deliberation, the National Office issued a detailed, favorable ruling (the "Subject Technical Advice") (App. F) which unequivocally agreed with, and adopted, the Petitioner's exact position in this case and thus held that the subject expenses were deductible under IRC §162(a).[16]

Subsequently, however, the Internal Revenue Service unaccountably revoked the Subject Technical Advice, reversed its position and ruled that the subject expenses were chargeable to Metropolitan's bad debt reserves pursuant to the provisions of IRC §595 and were therefore not deductible under IRC §162(a).[17]

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[15]"Technical advice" is guidance by the National Office of the Internal Revenue Service as to the interpretation and proper application of the Internal Revenue Code to a specific set of facts which is furnished to a District Office of the Internal Revenue Service in connection with the examination of a taxpayer's return. Treas. Reg. §601.105(b)(5)(i)(a).

[16]The National Office reached the identical conclusion on the same analysis in another Technical advice issued in 1972 (the "1972 Technical Advice"), ruling that the post-foreclosure costs there in issue incurred by a Missouri savings and loan association—various post-foreclosure operating expenses, including minor repairs, routine maintenance, insurance and taxes —were deductible under IRC §162(a). (App. G).

[17]Shortly after its reversal of position with respect to the deductibility of the subject expenses, the Internal Revenue Service issued Rev. Rul. 73-116 upon the "reasoning" of which the Commissioner relies for his position in these proceedings.

As a result, federal income tax deficiencies were assessed against Metropolitan for the taxable years 1968 and 1969 in the amounts of $47,207 and $7,975, respectively.

2. The Tax Court.

Petitioner sought a redetermination of the tax deficiencies in issue in the United States Tax Court. The case was tried solely on stipulated facts before one Tax Court judge who, in a wholly unreasoned, unreviewed opinion, demonstrably lacking in comprehension of the fundamental issues and fraught with senseless contradictions and question-begging conclusions, not only totally disregarded the binding effect of the Secretary's legislative Regulations under IRC §595, but more seriously contravened the explicit provisions thereof directly on point, ruled that the subject expenses were chargeable to Metropolitan's bad debt reserves pursuant to IRC §595 and therefore were not deductible under IRC §162(a).

In so ruling, *the Tax Court failed even to address, much less to analyze, Petitioner's argument which is absolutely dispositive of this case*: prior to the enactment of IRC §595, the post-foreclosure expenses in issue were *not* chargeable to Metropolitan's bad debt reserves; *IRC §595 did not change the tax treatment of such post-foreclosure expenses;* thus, the post-foreclosure expenses in issue cannot be chargeable to Metropolitan's bad debt reserves under IRC §595; and, therefore, the Tax Court's decision, as adopted by the Ninth Circuit, must *a fortiori* be wrong since it concluded that the post-foreclosure expenses in issue were not deductible solely because they were chargeable to Metropolitan's bad debt reserves.[18]

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[18]See pages 19-23 *infra*.

3. The Ninth Circuit.

Incredibly, the Ninth Circuit, totally abdicating its appellate responsibility in violation of the jurisdictional mandate of 26 USC §7482(a),[19] affirmed the unreviewed opinion of *the Tax Court* Judge *without a shred of independent analysis or reasoning* out of "substantial deference" to the "presumptive expertise" of the Tax Court:[20]

> "This case presents precisely the type of issues with respect to which we should accord *substantial deference* to the Tax Court. The resolution of such technical issues affecting a single industry is a task for which the Tax Court is well suited. For this reason alone we would be *reluctant to overturn* the Tax Court's judgment." (App. A at 3-4) (Emphasis added).

VIII
REASONS FOR GRANTING THE WRIT.

A. This Case Involves an Extremely Important and Novel Question of Federal Law Which Should Be Resolved by This Court.

1. This case, just as the *Lincoln* case, involves an extremely important question of federal income tax law of first impression which affects the thrift industry on a nationwide basis.[21] The significance and continu-

[19]See pages 25-27 *infra.*

[20]Since the Ninth Circuit completely "adopted" the Tax Court Judge's opinion, all references to the substantive aspects and errors of the decisions below will be to the Tax Court's decision.

[21]Actually, this case has an even wider significance and impact than *Lincoln* since mutual savings banks (without capital stock) and cooperative banks (without capital stock) are also affected. IRC §§593(a) and 595(a); Treas. Reg. §1.595-(1)(a).

ing impact of this issue on the nation's primary residential mortgage lenders present the same basic and compelling grounds for certiorari as those which this Court found sufficient to require review by certiorari in *Lincoln*—namely, to definitively resolve an industry-wide tax issue of extreme importance and continuing significance in order to forestall the inevitable multi-circuit litigation (and the concomitant administrative burdens on the thrift industry, the government and the courts) which must necessarily ensue if an issue of such magnitude is not conclusively resolved by this Court.

2. The decision of the Tax Court, which the Ninth Circuit "adopted", is so palpably wrong and so poorly "reasoned" that it raises serious and substantial questions about the scope and "pre-emptive" effect of IRC §595 as it applies to the deductibility of *all* types of post-foreclosure expenses, not just post-foreclosure disposition expenses. This uncertainty will no doubt precipitate substantial, additional litigation unless this Court intervenes *now* to resolve these critically important questions once and for all.

The cornerstone of the Tax Court's "analysis" in this case is its conclusion that, although there are ambiguities,[22] the most reasonable interpretation of IRC §595

> ". . . is that *all* tax results of foreclosures, including the expenses of disposing of the foreclosed

[22]The Tax Court obviously overlooked or consciously ignored the cardinal rule of construction, which has been universally embraced by the Courts, including this Court, that all doubts about the meaning of the tax laws must be resolved *strongly against the government and in favor of the taxpayer. Gould v. Gould,* 245 U.S. 151, 153 (1917); *United States v. Merriam,* 263 U.S. 179, 187-88 (1923); see also *Allstate Insurance Company v. U.S.,* 459 F.2d 863, 169 (9th Cir. 1974).

property, are to be accounted for through adjustments to the association's reserve for losses from qualifying loans." (App. B at 13) (Emphasis added).[23]

This is demonstrably, almost embarrassingly, wrong.

Indeed, how could the Tax Court possibly conclude that *all* post-foreclosure expenses are chargeable to a savings and loan association's bad debt reserves pursuant to the provisions of IRC §595 when, as even the Tax Court's opinion itself expressly acknowledges (App. B at 22-24), the Secretary's binding, legislative Regulations specifically provide that post-foreclosure expenses are *not* chargeable to a savings and loan association's bad debt reserves under IRC §595 in the absence of accountability therefor under applicable local law, but rather are separately deductible under IRC §162(a)? Treas. Reg. §1.595-1(e)(8) (ex. 2). (App. E at 40).

This blatant contradiction not only epitomizes the Tax Court's defective "reasoning" in this case but also persuasively demonstrates that its premise of "exclusivity" is not only misguided and ill-considered, but more importantly is totally false—obviously, if IRC §595 were truly exclusive, *no* post-foreclosure expenses would *ever* be deductible.

Yet, as even the Tax Court expressly concedes, this is not so. (App. B at 22-24). In fact, the Internal Revenue Service itself has expressly ruled,

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[23]See also App. B at 15 where the Tax Court, *by implication no less*, further concludes that the absence of any reference to IRC §162(a) in IRC §595 "reflects a congressional intent that *all* expenses, including those related to the sale of the foreclosed property, are to be treated under IRC Section 166 bad debt provisions." (Emphasis added).

not once but twice, that post-foreclosure expenses, such as those in issue, for which there is no accountability under applicable local law are not chargeable to a savings and loan association's bad debt reserves but rather are separately deductible under IRC §162(a).[24] Furthermore, the Regulations under IRC §595 make it indisputably clear that IRC §595 is *not* the exclusive provision of the Code which governs *all* tax consequences of mortgage foreclosures by savings and loan associations but rather is only *one* of several provisions of the Code which might be applicable depending on the issues involved and the underlying facts and circumstances.[25]

The evidence is thus overwhelming that, contrary to the Tax Court's erroneous conclusion, IRC §595 is *not* exclusive and that a savings and loan association's bad debt reserves are not to be treated as the non-

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[24]See the Subject Technical Advice (App. F) and the 1972 Technical Advice (App. G). These rulings constitute persuasive evidence of the true meaning and interpretation of IRC §595 and the Regulations promulgated thereunder. *Hanover Bank v. CIR,* 369 U.S. 672, 686 (1962); *Philadelphia Savings Fund Society v. U.S.*, 167 F.Supp. 814, 815 (E.D. Penn. 1958), *aff'd* 269 F.2d 853 (3rd Cir. 1959).

[25]For example, Treas. Reg. §1.595-1(e)(3) provides that post-foreclosure expenses which constitute capital expenditures are *not* to be considered as part of the foreclosed property in respect of which incurred and are *not* governed by IRC §595. Rather, when foreclosed property is ultimately sold or otherwise disposed of, "the portion of the amount realized which is allocable to such capital improvements *shall be treated under the applicable rules governing the sale or other disposition of such property and without regard to Section 595*". Treas. Reg. §1.595-1(e)(3) (Emphasis added). (App. E at 34-35). Similarly, Treas. Reg. §1.595-1(e)(6) provides that any portion of a deficiency judgment collected from a borrower by a savings and loan association which, under local law, constitutes interest is to be treated and characterized *separately* as interest income and thus is *not* to be credited to a savings and loan association's bad debt reserves pursuant to IRC §595. (App. E at 36-37).

deductible repository for all post-foreclosure expenses. Unfortunately, however, the decisions below provide absolutely no reasoned guidance as to the parameters, if any, of IRC §595's effect on the deductibility or non-deductibility of post-foreclosure expenses by savings and loan associations under IRC §162(a).

Are *all* post-foreclosure expenses non-deductible as the Tax Court concluded? Is *accountability* or *non-accountability* the dispositive factor in determining the deductibility or non-deductibility of post-foreclosure expenses as the Secretary's controlling Regulations expressly provide? Is the *type* of expense involved (*e.g.*, disposition costs as distinguished from maintenance, insurance or taxes pending disposition) relevant as the Tax Court's opinion suggests? Or is it the *nature of the property* (*e.g.*, income or non-income producing) with respect to which the expenses involved are incurred which govern as the Commissioner argued and which the Tax Court's opinion also suggests?

These are not merely idle or academic questions. Indeed, in connection with a recent examination of a tax return of Petitioner for a taxable year not involved in this appeal, an agent for the Internal Revenue Service has taken the position that, in accordance with the decisions below, post-foreclosure maintenance expenses incurred by Petitioner in respect of non-income producing foreclosed security property pending a disposition thereof are not deductible under IRC §162(a), but rather must be charged to Petitioner's bad debt reserves pursuant to the provisions of IRC §595, even

in the absence of accountability therefor under applicable California law.[26] This position is, of course, directly contradicted by the 1972 Technical Advice in which the Internal Revenue Service itself expressly ruled that post-foreclosure expenses for which there is no accountability under applicable local law are deductible under IRC §162(a) *irrespective of whether the foreclosed security property involved is income-producing or non-producing income property*. (App. G at 48).

It is thus manifestly clear that, unless this Court rectifies the egregiously incorrect and unreasoned decisions below, confusion concerning the scope of IRC §595's "pre-emptive" effect on the deductibility of post-foreclosure expenses by savings and loan associations under IRC §162(a) will continue to abound and substantial and unnecessary litigation will proliferate.

B. This Case Has Been Decided in a Way Which Is in Direct Conflict With Applicable Decisions of This Court.

1. It has not been, and cannot be, contended by the government that the Secretary's controlling Regulations under IRC §595 are unreasonable or inconsistent with IRC §595. Indeed, these Regulations were specifically promulgated pursuant to the express congressional directive set forth in IRC §595(d) that the Secretary

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[26]Apparently, this position is based on inference from the Tax Court's statement that Treas. Reg. §1.595-1(e)(8) (exs. 1 and 2) deals only with costs of maintaining property held by a creditor while such property is *rented*. (App. B at 23-24).

prescribe such Regulations *as he deemed necessary to carry out the purposes of IRC §595* (App. D at 28) and, as such, have the force and effect of law.[27]

Section 1.595-1(e)(7) of these binding, legislative Regulations expressly and unambiguously provides that IRC §595 *did not change* the tax treatment of post-foreclosure expenses except post-foreclosure depreciation.[28] Specifically, Treas. Reg. §1.595-1(e)(7) states, in relevant part, that:

> "Section 595 did not change the treatment of rents, royalties, dividends, interest or similar amounts received or accrued by the creditor with respect to . . . [foreclosed] property, *nor does it change the treatment of expenses incurred with respect to such property.*" Treas. Reg. §1.595-1(e)(7). (App. E at 38) (Emphasis added).

The dispositive effect of Treas. Reg. §1.595-1(e)(7) on this case is undeniably clear: since the post-foreclosure expenses in issue would not have been chargeable to Metropolitan's bad debt reserves prior to the enactment of IRC §595,[29] and since the con-

[27]See pages 6-8 *supra.*

[28]The reason, of course, why post-foreclosure depreciation is not allowable as a deduction is that foreclosed property is, for federal income tax purposes, deemed to have the characteristics of the underlying debt involved—by statute, a *non-capital, non-depreciable* asset. IRC §§595(b) and 1221. See *Burbank Liquidating Corp. v. CIR*, 39 TC 999 (1963), *aff'd in part and rev'd in part* 355 F.2d 125 (9th Cir. 1964). Post-foreclosure depreciation is not included as part of the subject expenses.

[29]*Post-foreclosure* expenses, such as those in issue, incurred by a savings and loan association *after foreclosure*, and for which there is *no accountability* between such lender and its borrower under applicable local law, are *not* required to be taken into consideration in computing the *bad debt* consequences of foreclosure *because such expenses are not chargeable to, and thus do not become part of, the underlying debt* and

trolling, legislative Regulations of the Secretary under IRC §595, *which have the force and effect of law*, expressly state that IRC §595 *does not change* the tax treatment of these expenses, it follows, *a fortiori*, and as a matter of law, that the post-foreclosure expenses in issue cannot be charged to Metropolitan's bad debt reserves.

The logic of this argument is unassailable; its conclusive effect on this case inexorable—the decisions below must be reversed because they are hopelessly and irreconcilably in conflict with the Secretary's binding, legislative Regulations directly on point and are therefore contrary to law. Cf. *Manhattan General Equipment Co. v. CIR, supra,* 267 U.S. at 134; *Dixon v. U.S. supra,* 381 U.S. at 74.

Yet, in an "opinion" which does not even focus on, much less attempt to answer, this dispositive argument, the Ninth Circuit has, by adopting the Tax Court's decision as its own, ruled that the post-foreclosure expenses in issue were non-deductible because they were chargeable to Metropolitan's bad debt reserves pursuant to the provisions of IRC §595.

How can this be?

How it is legally or logically possible for the post-foreclosure expenses in issue, which, prior to the adoption of IRC §595, were not chargeable to Metropolitan's bad debt reserves, to become chargeable to Metropolitan's bad debt reserves under IRC §595 when the

therefore are *not relevant* for *bad debt* purposes. See, *e.g., Hadley Falls Trust Co. v. U.S.*, 22 F.Supp. 346, 351-52 (D. Mass. 1938), aff'd in part and rev'd in part, 110 F.2d 887 (1st Cir. 1940). Cf. *Murray v. CIR*, 21 TC 1049 (1954), *aff'd* 232 F.2d 742 (9th Cir. 1956); *Penn Athletic Club Bldg. v. CIR*, 10 TC 919, 942 (1948), *aff'd* 176 F.2d 939 (3rd Cir. 1949).

Regulations of the Secretary under IRC §595 pointedly and unequivocally state that IRC §595 did not change the tax treatment of these post-foreclosure expenses? HOW!!?

Petitioner has been asking this question for approximately eight years now and yet, amazingly, no one except Petitioner—not the Commissioner, either in his published ruling on this very issue (App. H)[30] or in his briefs in the proceedings below; not the Tax Court; not counsel for the Commissioner at oral argument before the Ninth Circuit; and, disappointingly, not even the Ninth Circuit—has even addressed this determinative question, much less answered it.

The reason is embarrassingly obvious. The only rational answer to this question—namely, that it is impossible, in the face of the Secretary's binding, legislative Regulations on point, to conclude that the post-foreclosure expenses in issue are chargeable to Metropolitan's bad debt reserves—ineluctably exposes the total fallacy of the Commissioner's position and the decisions of both the Tax Court and the Ninth Circuit in this case.

The plain and inescapable fact is that the post-foreclosure expenses in issue, for which there was *no accountability* between Metropolitan and its borrowers under applicable California law, and which thus *were not chargeable to the underlying defaulted real property loans involved,* simply do not belong in Metro-

[30]Not only is Rev. Rul. 73-116 totally devoid of any reasoning, but, unbelievably, does not even mention or refer to the Secretary's Regulations under IRC §595 at all! Equally amazing is the fact that this ruling, which sets forth the position of the Commissioner in this appeal, was not at all analyzed by the Tax Court and was not even mentioned by the Ninth Circuit.

politan's *bad debt reserves.* And, rightly so. After all, IRC §595 deals only with the *bad debt consequences* of mortgage foreclosure and does not apply to post-foreclosure expenses which do not effect and become part of the underlying debt because the borrower has no accountability therefor.

Nevertheless, both the Tax Court and the Ninth Circuit, by holding that the post-foreclosure expenses in issue must be charged to Metropolitan's bad debt reserves pursuant to the provisions of IRC §595, have taken it upon themselves to *overrule* the plain and unambiguous provisions of the Secretary's controlling, legislative Regulations to the contrary. This wrongful and injudicious encroachment upon the unquestionably valid exercise by the Secretary of an expressly delegated legislative function clearly transcends the judicial prerogative (*See Hanover Bank v. CIR, supra,* 369 U.S. at 687; *Manufacturers Hanover Trust Co. v. CIR,* 431 F.2d 653, 675 (9th Cir. 1961)) and is thus irreconcilably inconsistent with this Court's clear and repeated injunction that Treasury Regulations, such such as those in issue, must not be overruled. *Fulman v. U.S., supra,* 434 US at 533; *Bingler v. Johnson, supra,* 394 U.S. at 749-50; *U.S. v. Correll, supra,* 389 U.S. at 306-07; *CIR v. South Texas Lumber Co., supra,* 333 U.S. at 501.

2. That the Tax Court and the "rubber-stamping" Ninth Circuit completely misunderstood the fundamental issue in this case is nowhere better demonstrated than by the Tax Court's preposterous conclusion (based on its egregious misapplication of this Court's decisions in the companion cases of *Woodward v. CIR,* 397 U.S. 572 (1970), and *United States v. Hilton Hotels,*

397 U.S. 580 (1970)), that the expenses of selling forecolsed property are *"inherently capital"* in nature and therefore must, in all instances and under all circumstances, be "capitalized" for bad debt purposes through charges to a savings and loan association's bad debt reserves pursuant to IRC §595. (App. B at 18-19).

This is utter nonsense. The most that can be said for *Woodward* and *Hilton Hotels* is that they stand for the proposition that costs and expenses incurred in connection with the disposition of *capital assets* constitute capital expenditures and therefore must be taken into consideration in determining the amount of *capital gain or loss* realized therefrom. *Woodward v. CIR, supra,* 397 U.S. at 575.

So what? It is obvious that costs and expenses incurred in connection with the disposition of *capital assets* should be taken into consideration in determining the amount of *capital gain or loss* realized therefrom. But what has this to do with the instant case? This case involves the tax treatment of certain post-foreclosure expenses incurred by Metropolitan in connection with the disposition of foreclosed security property—*a non-capital asset*—which, by virtue of the provisions of IRC §595, is treated as a *bad debt transaction* for federal income tax purposes.[31]

Clearly, the statutes and policy considerations involved in resolving the fundamental issue herein—whether the subject expenses should be reflected in Metropolitan's *bad debt reserves*—are so totally different than those involved in *Woodward* and *Hilton Hotels* as to render such cases totally irrelevant. Cf. *Cushing*

[31]See note 32 *infra.*

Stone, Inc. v. U.S., 535 F.2d 27, 33 (Ct. Cls. 1976); *Sharples v. U.S.,* 533 F.2d 550, 554-55 (Ct. Cls. 1976).

It is apparent that the Tax Court blatantly misapplied *Woodward* and *Hilton Hotels* to support its errant conclusion that the subject expenses were "inherently capital" in nature and therefore are chargeable to Metropolitan's bad debt reserves. Indeed, an analysis of this Court's opinions in *Woodward* and *Hilton Hotels* reveals that, far from embracing the nonsensical concept of "inherent capitalization" inferred by the Tax Court, this Court actually adopted the converse postulate—namely, that whether or not a particular expense must be capitalized for tax purposes must be determined by reference to the *nature of the underlying transaction* involved in light of the statutes and policy considerations in issue, and not on the basis of the *type* of expense in question. *Woodward v. CIR, supra,* 397 U.S. at 578.

Were it otherwise, this Court's venerable, landmark decision in *Corn Products Refining Co. v. CIR,* 350 U.S. 46, 51-52 (1955), would be rendered meaningless.

C. The Ninth Circuit Has so Far Departed From the Accepted and Usual Course of Judicial Proceedings as to Call for the Exercise of This Court's Power of Supervision.

Astoundingly, in this, the most important tax case affecting the savings and loan and thrift industry since the *Lincoln* case, the Ninth Circuit, in a truncated, "rubber-stamp" opinion, which, even in its brevity, exposes a fundamental fallacy of the Commissioner's posi-

tion herein,[32] has totally breached its statutory duty of independent and impartial appellate review mandated by 26 USC 7482(a), the very basis of the Ninth Circuit's jurisdiction herein, by affirming a patently "bad" and totally erroneous, unreviewed decision of one Tax Court judge out of "*substantial deference*" to the Tax Court because "the resolution of . . . technical issues affecting a single industry is the task for which the Tax Court is well suited." (App. A at 3-4).

This is wrong and inexcusable.

Indeed, this is precisely the situation Congress sought to obviate by the enactment, in 1948, of 26 USC §1141(a), now 26 USC §7482(a), which unequivocally mandates Circuit Courts to review decisions of the Tax Court ". . . *in the same manner and to the same extent as decisions of the District Court in civil actions tried without a jury* . . ." 26 USC §7482(a) (Emphasis added). The Ninth Circuit's admitted "substantial deference" to, and its stated "reluctance" to overturn, the Tax Court's decision make it painfully clear that the Ninth Circuit did not comply with this mandate in reviewing the Tax Court's decision below.

It is beyond cavil that fundamental principles of sound judicial administration, basic fairness and just plain common sense require, especially in a case of

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[32]As stated by the Ninth Circuit, the Commissioner's argument rests on the assumption that foreclosed security property constitutes a *capital asset*. (App. A at 3). Yet, under the very terms of IRC §595 itself, foreclosed security property is considered to have the same characteristics as the underlying indebtedness for which such property was security and is therefore deemed to constitute a *non-capital* asset for federal income tax purposes. IRC §§595(b) and 1221; *see also Burbank Liquidating Corp. v. CIR, supra;* Rev. Rul. 73-558, 1973-1 CB 298; Rev. Rul. 72-238, 1972-1 CB 65.

this importance, involving, as it does, such an extremely significant and novel issue of law which affects an entire industry on a continuing basis, that the Ninth Circuit not only scrupulously, *impartially* and *independently* review the decision of the Tax Court below, but also render a full and complete opinion which carefully addresses and thoughtfully analyzes the issues involved and arguments raised, and expressly sets forth the reasoning upon which the ultimate conclusions are based, so that all affected properly can be guided by its decision.

That *none* of this was done in this vitally important case constitutes such a departure from the accepted and usual course of judicial proceedings as to require the exercise of this Court's power of supervision herein.

IX
CONCLUSION.

For all of the reasons set forth herein, a writ of certiorari to review the judgment of the Ninth Circuit below should issue.

Dated: January 23, 1980.

Respectfully submitted,

HILL, WYNNE, TROOP & MEISINGER,
ROBERT J. WYNNE,

Counsel for Petitioner Allstate Savings and Loan Association.

APPENDIX A.

Opinion.

United States Court of Appeals for the Ninth Circuit.

Allstate Savings & Loan Association, Successor-in-Interest to Metropolitan Savings and Loan Association of Los Angeles, Petitioner-Appellant, v. Commissioner of Internal Revenue, Respondent-Appellee. No. 77-3221.

Filed: July 13, 1979.

Appeal from a Decision of the United States Tax Court.

Before: TRASK, GOODWIN and SNEED, Circuit Judges.

SNEED, Circuit Judge:

Appellant-taxpayer, Allstate Savings and Loan Association, appeals to set aside a Tax Court judgment for the Commissioner. Appellant had sought a redetermination of alleged tax deficiencies for the years 1968 and 1969. On December 17, 1973, the Commissioner determined that appellant's predecessor-in-interest, Metropolitan Savings & Loan Association, had erroneously deducted under section 162(a) of the Internal Revenue Code, certain selling commissions and other expenses paid or incurred in selling foreclosed security property. The Commissioner further determined that such post-foreclosure expenses should be treated under section 595 as costs of disposing of security property, thereby reducing Metropolitan's reserve for bad debts for those years. The Tax Court agreed with the Commissioner's construction of the applicable statutes. The Tax Court opinion is reported at 68 T.C. 310 (1977). Our jurisdiction is derived from section 7482 of the Internal Revenue Code of 1954. We affirm.

All the facts are stipulated and are set forth in the Tax Court opinion in 68 T.C. at 311-12. A condensed statement of these facts is as follows:

During the tax years 1968 and 1969, Allstate's predecessor, Metropolitan Savings and Loan Association (Metropolitan), reported its income on a cash receipts and disbursements method of accounting and used the reserve method in computing its bad debt losses, pursuant to section 593(a) and section 166(c) of the Internal Revenue Code of 1954.

During the 1968 tax year, Metropolitan sold forty tracts of foreclosed real estate at an aggregate gross selling price of $4,262,000, incurring direct post-foreclosure expenses, including real estate brokerage commissions, in the aggregate of $223,546. During tax year 1969, Metropolitan sold 17 foreclosed tracts at an aggregate gross selling price of $1,532,593, incurring direct post-foreclosue expenses in the aggregate of $37,764, including brokerage commissions totaling $11,573. On its tax returns for 1968 and 1969, Metropolitan deducted the brokerage commissions and other post-foreclosure expenses under section 162(a) of the Code.

The Commissioner, in the notice of tax deficiency, determined that the commissions and other expenses incurred in selling foreclosed property were not deductible under section 162(a) but rather were required to be taken into account through increases in Metropolitan's reserve for bad debts, as costs of disposing of such property, under section 595 of the Code. This resulted in an increase of Metropolitan's 1968 and 1969 taxable income by the respective amount of the disallowed expenses and a corresponding decrease

of such income, by reason of the additions to the reserve, in the amount of $134,128 for 1968 and $22,658 for 1969. Thus, the net effect of the Commissioner's action was to increase Metropolitan's 1968 taxable income by $89,418 and that of 1969 by $15,106. The alleged deficiencies primarily are the result of these adjustments.

Appellant contends that the Commissioner's adjustments are improper because (1) post-foreclosure expenses should be fully deductible under section 162(a) except where applicable state law makes the borrower accountable therefor to the lender, a situation not present in this case, (2) such expenses are "ordinary and necessary" expenses incurred by Metropolitan in carrying on its trade or business, and (3) the term "amount realized," as used in the second sentence of section 595(b), means "the sum of money received plus the fair market value of the property (other than money) received" undiminished by foreclosure expenses.

The Commissioner's arguments essentially rest on the propositions that selling expenses generally reduce the amount realized on the disposition of a capital asset, *see Woodward v. Commissioner*, 397 U.S. 572, 574-75 (1970), and that only by so treating expenses such as foreclosure expenses can the purposes of section 595 be achieved. The latter is true, the Commissioner argues, because section 595 treats the foreclosure and sale of property as a single transaction consisting of repayment of the debt in which foreclosure expenses reduce the amount so repaid.

This case presents precisely the type of issues with respect to which we should accord substantial deference to the Tax Court. The resolution of such technical issues affecting a single industry is a task for which

the Tax Court is well suited. For this reason alone we would be reluctant to overturn the Tax Court's judgment.

In this instance, however, we have analyzed the issues independently and find that we wholeheartedly agree with the Tax Court's decision and its accompanying reasons. We, therefore, affirm its judgment and adopt its analysis of the issues. It will serve no useful purpose to extend this opinion by repeating this analysis.

AFFIRMED.

APPENDIX B.

Opinion.

68 T. C. No. 27, United States Tax Court.

ALLSTATE SAVINGS & LOAN ASSOCIATION, Successor in Interest to Metropolitan Savings & Loan Association of Los Angeles, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 1674-74. Filed June 7, 1977.

Held, the expenses incurred by a building and loan association in selling foreclosed property in 1968 and 1969 are not deductible under sec. 162(a), I.R.C. 1954, but must be taken into account in making charges and credits to the association's reserve for losses from qualifying real property loans pursuant to sec. 595, I.R.C. 1954.

Robert J. Wynne, for the petitioner.

Stephen B. Zorick, Jr., for the respondent.

FEATHERSTON, *Judge:* Respondent determined the following deficiencies in petitioner's Federal income taxes as successor in interest to Metropolitan Savings & Loan Association of Los Angeles:

1968	$47,207
1969	$ 7,975

Other issues having been settled by the parties, the only issue for decision is whether commissions and other selling expenses incurred by petitioner in disposing of foreclosed property are deductible under section 162[1] or are chargeable to the reserve for losses from qualified loans pursuant to section 595.

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[1]All section references are to the Internal Revenue Code of 1954, as in effect during the tax years in issue, unless otherwise noted.

All the facts are stipulated.

Metropolitan Savings & Loan Association of Los Angeles (hereinafter Metropolitan) was organized on or about June 16, 1936, under the laws of the State of California, as a domestic savings and loan association. Petitioner Allstate Savings & Loan Association (hereinafter Allstate or petitioner) is the successor in interest to Metropolitan which merged with petitioner on June 30, 1970. Pursuant to the merger, petitioner succeeded to all rights in the property of, and became subject to all debts and liabilities of, Metropolitan. During 1968 and 1969, Metropolitan reported its income on the basis of the calendar year, utilizing the cash receipts and disbursements method of accounting. Metropolitan used the reserve method in deducting its bad debt losses as provided by sections 593(b) and 166(c).

Metropolitan's principal activities during the years in issue consisted of acquiring cash savings from the public and lending money. Its loans primarily were loans secured by real property. Under California law, real property loans made by Metropolitan during the base period[2] could not exceed a prescribed percentage of the value of the property securing them. Pursuant to standards prevailing in the California savings and loan industry during the base period, the appraised value of security property was not diminished by such anticipated acquisition and resale costs as brokerage commissions and other selling expenses.

Periodically throughout Metropolitan's operations, borrowers defaulted in the payment of real property loans or in the performance of other obligations imposed under the terms of deeds of trust securing payment of the loans. In order to collect on these defaulted

[2]"Base period" means the period beginning Jan. 1, 1960, and ending June 30, 1970.

loans, Metropolitan was required to initiate foreclosure proceedings. In each foreclosure case during the base period, Metropolitan acquired such property through nonjudicial foreclosure, usually by exercise of a power of sale granted the lender under the terms of a trust deed. Once the property was acquired through foreclosure, Metropolitan attempted to dispose of it as soon as possible in order to maximize recovery of the loan for which the property was security.

As a result of its acquisition of property under foreclosure proceedings, Metropolitan paid or incurred various foreclosure expenses. Under California law, each parcel of property was the sole security for the loan, and the borrowers were not accountable for any foreclosure expenses paid or incurred by Metropolitan.

During 1968, Metropolitan sold 40 tracts of foreclosed real estate at an aggregate selling price of $4,262,600 and, on its 1968 Federal income tax return, deducted the $223,546 of brokerage commissions as ordinary and necessary business expenses under section 162(a). During 1969, Metropolitan sold 17 tracts of foreclosed real estate at a gross selling price aggregating $1,532,593 and deducted direct post-foreclosure expenses in the total amount of $37,764.[3]

[3]The following items of direct post-foreclosure expenses were included in the deduction:

Loan costs	$ 505.00
Title costs	5,409.49
Brokerage commissions	11,753.00
Insurance pro-rations	3,072.16
Escrow fees	2,493.20
Document fees	95.00
Inspection fees	2,795.80
Bonds	3,095.16
Recording fees	25.60
Tax service and credit report fees	80.00
Veterans Administration fees	275.00
Refurbishing costs	4,447.00
Rent pro-rations	2,030.19

On December 17, 1973, respondent determined deficiencies in Metropolitan's Federal income taxes for 1968 and 1969, denying the deduction claimed by Metropolitan under section 162(a) for commission and other expenses paid or incurred in selling foreclosed property. Respondent further determined that such commission and other expenses should be treated under section 595 as costs of disposing of such property, thereby increasing Metropolitan's reserve for bad debts for those years.

Under section 595(a),[4] a building and loan association which, at a foreclosure sale, bids in security property as a general rule does not recognize gain or loss and does not become entitled to a bad debt deduction

[4]Sec. 595 states, in part, as follows:

SEC. 595. FORECLOSURE ON PROPERTY SECURING LOANS.

(a) Nonrecognition of Gain or Loss as a Result of Foreclosure.—In the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

(b) Character of Property.—For purposes of sections 166 and 1221, any property acquired in a transaction with respect to which gain or loss to an organization was not recognized by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. Any amount realized by such organization with respect to such property shall be treated for purposes of this chapter as a payment on account of such indebtedness, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to allowance of a deduction for bad debts) apply.

(c) Basis.—The basis of any property to which subsection (a) applies shall be the basis of the indebtedness for which such property was secured (determined as of the date of the acquisition of such property), properly increased for costs of acquisition. * * *

at that time.[5] Rather, under section 595(b), the property so acquired is considered, for purposes of section 166, as "property having the same characteristics as the indebtedness for which such property was security." Any "amount realized" by the association with respect to such property is treated as a payment on account of the indebtedness, and any loss with respect thereto is treated as a bad debt to which section 166 shall apply.

In the case of an organization which accounts for bad debt losses through reserves, as does petitioner, the net effect of section 595(a) and (b) is to defer recognition of gain or loss as a result of a foreclosure until such time as the creditor sells or otherwise disposes of the foreclosed property. The association's investment in the borrower's indebtedness is carried forward in the form of the security property. Upon the property's sale, the gain or loss is treated as a credit or charge to the bad debt reserve, as the case may be, depending upon the results of the sale. Under section 595(c), such gain or loss is to be computed by using the basis of the indebtedness as the basis for the security property, determined as of the date of acquisition and "properly increased for costs of acquisition."

Section 595 says nothing specifically about how to handle the costs of disposing of the foreclosed property, such as brokerage commissions, title costs, revenue stamps, escrow fees, and other similar expenses. Petitioner contends that such expenses are separately de-

[5]This general rule is subject to the qualification that if a proper appraisal establishes that the fair market value of the acquired property is less than the adjusted basis of the property, the association may treat the difference as a worthless debt and may so treat further declines in value. Sec. 1.595-1(e)(1), Income Tax Regs.

ductible under section 162(a) as ordinary and necessary business expenses and do not affect the adjustment to the bad debt reserve. Respondent maintains that those expenses reduce the amount to be applied on the former owner's indebtedness and should be taken into account in computing the amount of the credit or charge to the bad debt reserve.

We agree with respondent.

Prior to 1952, domestic building and loan associations were exempt from Federal income tax. The Revenue Act of 1951 subjected them to regular corporate income tax but allowed a special deduction for additions to bad debt reserves. This special deduction proved to be so large that such organizations remained virtually tax exempt until the Revenue Act of 1962 added sections 593 and 595 to the 1954 Code. H. Rept. No. 1447, 87th Cong., 2d Sess., p. 32 (1962), 1962-3 C.B. 703, 746.

The principal technique adopted in sections 593 and 595 for subjecting these organizations to heavier Federal income taxes was a drastic modification of the bad debt reserve provisions. Under section 593(c), these associations were directed to maintain three accounts to which additions were to be made with respect to bad debts: (1) a reserve for "losses on qualifying real property loans," (2) a reserve for "losses on nonqualifying loans," and (3) a supplemental reserve for losses on loans. See *Leesburg Federal Savings & Loan Association v. Commissioner,* 55 T.C. 378, 383 (1970). The additions to the first two of these reserves are designed to determine the amount deductible under section 166(c) as a reasonable addition to the reserve for bad debts. These two accounts function "as a

substitute for deduction of debts as they are determined to be worthless." *Levelland Savings & Loan Assoc. v. United States,* 421 F.2d 243, 246 (5th Cir. 1970).[6]

Additions to the reserve for losses on qualifying real propery loans, which are involved in the instant case, are to be made pursuant to certain prescribed methods, including the "percentage of taxable income method."[7] Under this method, used by Metropolitan

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[6]S. Rept. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 703, 751 explains:

> The reserves which are required by the bill to be established—that is, the reserve for losses on qualifying real property loans, the reserve for losses on nonqualifying loans, and the supplemental reserve for losses on loans—are required to be treated as bad-debt reserves for all tax purposes (except that no deduction is allowed for any addition to the supplemental reserve). Thus, although these reserves are termed reserves for "loans," they are reserves for bad debts; * * *

[7]This method is prescribed by sec. 593(b)(2) which, in the form in effect during 1968 and 1969, is as follows:

> (b) Addition to Reserves for Bad Debts.—
>
> (1) In general.—For purposes of section 166(c), the reasonable addition for the taxable year to the reserve for bad debts of any taxpayer described in subsection (a) shall be an amount equal to the sum of—
>
> (A) the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on non-qualifying loans, plus [amounts computed pursuant to prescribed methods, including the percentage of taxable income method]
>
> * * *
>
> (2) Percentage of taxable income method.—The amount determined under this paragraph for the taxable year shall be the excess of—
>
> (A) an amount equal to 60 percent of the taxable income for such year, over
>
> (B) the amount referred to in paragraph (1)(A) for such year,
>
> but the amount determined under this paragraph shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses

(This footnote is continued on next page)

during the years in controversy, an amount determined to be to the excess of 60 percent of the taxable income (computed without this deduction) over the amount allowed for nonqualifying loans was to be added to the bad debt reserve. But the addition could not exceed the amount necessary to increase the balance as of the close of the taxable year to 6 percent of the loans outstanding at such time and was subject to other limitations not pertinent in this case.

For the years in controversy, petitioner claimed and was allowed the maximum permissible addition to its reserve for losses from qualifying loans and, consequently, the maximum permissible bad debt deduction under section 166. In addition, petitioner deducted under section 162 the expenses incurred in selling the foreclosed property, and respondent denied those deductions.[8]

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on qualifying real property loans to 6 percent of such loans outstanding at such time. For purposes of this paragraph, taxable income shall be computed (i) by excluding from gross income any amount included therein by reason of subsection (f), and (ii) without regard to any deduction allowable for any addition to the reserve for bad debts.

By subsequent legislation, the percentage has been scaled downward and other changes not here pertinent have been made.

[8]The notice of deficiency issued to petitioner explains the adjustment in dispute as follows:

(g) It is determined that commission expenses of $223,546.00 in 1968 and $37,764.00 in 1969 are not deductible under section 162 of the Internal Revenue Code. Such expenditures are part of a cost of sale of REO (Real Estate owned) property and as such are chargeable to the reserve for losses from qualified loans under section 595 of the Internal Revenue Code. Accordingly, the taxable income is increased by $223,546.00 in 1968 and by $37,764.00 in 1969.

(h) It is determined that you are entitled to a bad debt deduction of sixty percent of the increase to taxable

While there are ambiguities in section 595, we agree with respondent that the most reasonable interpretation of the section is that all the tax results of foreclosures, including the expense of disposing of the foreclosed property, are to be accounted for through adjustments to the association's reserve for losses from qualifying loans. The foreclosed property becomes a substitute for the debt. Any amount realized with respect to such property is treated as a payment on account of the debt, and any loss with respect to such property is treated as a bad debt.

Prior to the enactment of section 595(a), gain or loss on a foreclosure, where a creditor-association bought in mortgaged property, was measured by the difference between the amount of the obligations of the debtor applied to the purchase or bid price and the fair market value of the foreclosed property.[9]

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income resulting from adjustment (g) above. The allowance is per section 593 of the Internal Revenue Code. Computation is as follows:

	Increase to Taxable Income		Adjustment
1968	$223,546.00 × 60%	=	$134,128.00
1969	37,764.00 × 60%	=	22,658.00

Accordingly, the taxable income is decreased by $134,-128.00 in 1968 and by $22,658.00 in 1969.

[9]Sec. 1.166-6(b), Income Tax Regs., on sales of mortgaged or pledged property is as follows:

(b) *Realization of gain or loss*—(1) *Determination of amount.* If, in the case of a sale described in paragraph (a) of this section, the creditor buys in the mortgaged or pledged property, loss or gain is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property.

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Upon the subsequent sale of property, still another taxable event occurred, with the creditor-association recognizing capital gain or loss or ordinary gain or loss, depending on whether the foreclosed property was a capital asset, property held primarily for sale in the ordinary course of business, or real property used in the taxpayer's business. S. Rept. No. 1881, 87th Cong., 2d Sess. 47, 1962-3 C.B. 704, 753; sec. 1.166-6(c), Income Tax Regs.

Sections 593 and 595, as we read them, were intended to telescope the foreclosure, purchase, and resale of such property and treat them as a single transaction so that there would be only one taxable event rather than two. And the tax consequences of that single event were to be determined not by reporting the gain or loss on the sale of the foreclosed property, as such, but through a credit or charge to the reserve for losses on qualifying real property loans. If the amounts received from the sale of the property are less than the unpaid indebtedness, a charge will be made to the reserve account. If such amounts exceed the indebtedness, a credit is made to that account. The proper charge or credit to the reserve account can be computed only by taking selling expenses as well as foreclosure costs into account. Thus, S. Rept. No. 1881, 87th Cong., 2d Sess. 48, 1962-3 C.B. at 754 explains:

> When the property is ultimately sold or disposed of, the difference between any amount realized and the original or previously reduced debt, is to be treated as ordinary loss or income and is to be charged, or credited, as the case may be, against the reserve for losses on qualifying real property loans.

(2) *Fair market value defined.* The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer.

Petitioner pins its case mainly upon the technical terms used in section 595.

First, petitioner has pointed out that section 595(b) provides that the foreclosed property "shall be considered as property having the same characteristics as the indebtedness for which such property was security." Since the costs of servicing indebtedness due an association are deductible as business expenses under section 162(a), petitioner has argued that the costs of liquidating foreclosed property should be similarly so deductible. But this argument overlooks the fact that the section 595(b) language on which petitioner relies is introduced with the limitation "For purposes of sections 166 and 1221." No mention is made of section 162(a). If any implication is to be drawn from this language, it is that the absence of any reference to section 162(a) reflects a congressional intent that all expenses, including those related to the sale of the foreclosed property, are to be treated under the section 166 bad debt provisions.

Next, petitioner maintains that the term "amount realized," used in the second sentence of section 595(b), has the same meaning as it is given in section 1001(b)—"the sum of any money received plus the fair market value of the property (other than money) received." Thus, petitioner would read section 595(b) to provide that the gross proceeds of the sale of foreclosed property, undiminished by any selling expenses, should be treated as a payment on the indebtedness,

leaving the selling expenses to be separately deducted under section 162(a).

But "amount realized" as used in the Code is not always limited by the literal provisions of section 1001(b). It is a term which takes its meaning from the context in which it is used. It may include the amount of a mortgage assumed by the purchaser or even the amount of a mortgage to which the property was subject at the time of the sale. *Crane v. Commissioner*, 331 U.S. 1, 13-14 (1947); *Parker v. Delaney*, 186 F.2d 455, 457-458 (1st Cir. 1950). In connection with the sale or exchange of residences under section 1034, the "amount realized" is computed by subtracting from the consideration received upon the sale precisely the same kinds of expenses as are here in dispute—commissions and expenses of advertising the property for sale, of preparing the deed, etc. Sec. 1.1034-1(b)(4), Income Tax Regs.[10]

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[10]Sec. 1.1034-1(b)(4), Income Tax Regs., provides as follows:

> (b) *Definitions.* The following definitions of frequently used terms are applicable for purposes of section 1034 (other definitions and detailed explanations appear in subsequent paragraphs of this regulation):
>
> (4) "Amount realized" is to be computed by subtracting
>
> (i) The amount of the items which, in determining the gain from the sale of the old residence, are properly an offset against the consideration received upon the sale (such as commissions and expenses of advertising the property for sale, of preparing the deed, and of other legal services in connection with the sale); from
>
> (ii) The amount of the consideration so received, determined (in accordance with section 1001(b) and regulations issued thereunder) by adding to the sum of any money so received, the fair market value of the property (other than money) so received. If, as part of the consideration for the sale, the purchaser either assumes a liability of the taxpayer or acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the "amount realized."

The Senate Committee Report accompanying the enactment of section 595 in explaining the operation of the section uses both the term "amount received" and the term "amount realized." S. Rept. No. 1881, 87th Cong., 2d Sess. 47-48, 1962-3 C.B. 753. The regulations define "amount realized" as used in section 595 to mean "an amount representing a recovery of capital, such as proceeds from the sale or other disposition of the property, payments on the original indebtedness made by or on behalf of the debtor" (including amounts received under Federal Housing Administration insurance contracts and Veterans Administration guarantees), and collections on deficiency judgments obtained against the debtor. Sec. 1.595-1(e)(6), Income Tax Regs. Thus, as used in section 595, the term means the amount obtained by the lending association on the foreclosure and disposition of the security property which is available for application on the borrower's indebtedness. Such amount can be computed only by taking into account the selling expenses as well as the acquisition expenses.

From the standpoint of a foreclosing loan association attempting to collect a debt which has gone bad, the expenses of selling the foreclosed property are as much a part of the cost thereof as the expense of acquiring title to it.[11] The proceeds of the sale

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[11]Costs of the foreclosure are added to the property's basis under sec. 1.595-1(d), Income Tax Regs., as follows:

> (d) *Basis of acquired property.* Section 595(c) provides that the basis of any property to which section 595(a) applies (hereinafter referred to as "acquired property")

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used to offset one such set of expenses represent the "recovery of capital," sec. 1.595-1(e)(6), Income Tax Regs., as much as the other. In *Woodward v. Commissioner*, 397 U.S. 572, 576 (1970), dealing with whether litigation expenses with respect to a capital asset should be capitalized or deducted, the Supreme Court observed that "such ancillary expenses [legal, brokerage, accounting, and or similar costs] incurred in acquiring *or disposing* of an asset are as much part of the cost of that asset as is the price paid for it [emphasis added]." "[W]e cannot see why the order in which these operations occurred * * * should make any difference in the characterization of the expenses." *United States v. Hilton Hotels Corp.*, 397 U.S. 580, 584 (1970).[12] Both sets of expenses must be paid before the lending institution can realize anything for

shall be the adjusted basis of the indebtedness for which such property was security, determined as of the date of acquisition of such property, properly increased for costs of acquisition. The date of acquisition is the date, determined under paragraph (b) of this section, on which the security property is reduced to ownership or possession by agreement or process of law. Costs of acquisition are expenditures incurred by the creditor (for example, fees for an attorney, master, trustee, auctioneer, for publication, acquiring title, clearing liens, filing and recording, and court costs) which are directly related to the foreclosure sale or proceeding, or to the other process used to reduce the security property to ownership or possession, or both, by agreement or process of law.

[12]Employing the same reasoning nearly all of the circuit courts of appeals have held that real estate brokerage commissions and related expenses incurred in a sec. 337 liquidation are offset against the selling price and are not deductible currently as ordinary and necessary expenses. *Page v. Commissioner*, 524 F.2d 1149 (9th Cir. 1975), affg. a Memorandum Opinion of this Court; *Of Course, Inc. v. Commissioner*, 499 F.2d 754 (4th Cir. 1974); *Connery v. United States*, 460 F.2d 1130 (3d Cir. 1972); *Lanrao, Inc. v. United States*, 422 F.2d 481 (6th Cir. 1970); *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968); *Alphaco, Inc. v. Nelson*, 385 F.2d 244 (7th Cir. 1967).

application on the defaulted debt. The property may be a capital asset or may be held primarily for sale, but the expenses of selling the foreclosed property are inherently capital in nature.

To avoid the impact of this reasoning, petitioner emphasizes that its foreclosures were "regular," "systematic," "ordinary," and "necessary" and argues that, therefore, its selling expenses are deductible under section 162(a). Implicit in this argument is a concession that, where the foreclosed property is a capital asset in the hands of the lending institution, the selling expenses must be capitalized. But adoption of this position would require a determination of the character of the business activities of the lending institution and would thus reopen an issue which section 595 was intended to set at rest.

Prior to the enactment of section 595, there was confusion as to whether property foreclosed by savings and loan associations should be treated as capital assets, property held primarily for resale, or property used in the taxpayer's business within the meaning of section 1231.[13] The committee report accompanying the enact-

[13]In G.C.M. 21497, 1939-2 C.B. 187, the Internal Revenue Service (IRS) ruled that property foreclosed and offered for sale by a savings and loan institution or bank was property held primarily for sale to customers in the ordinary course of business and the resulting gain or loss was ordinary in character. In *Kanawha Valley Bank v. Commissioner*, 4 T.C. 252 (1944), this Court ruled that property foreclosed by a bank, forbidden by State law to carry on a real estate business, was a capital asset. Because of this decision, in G.C.M. 24910, 1946-1 C.B. 101, the IRS ruled that property foreclosed and sold was a capital asset. But see *Girard Trust Corn Exchange Bank v. Commissioner*, 22 T.C. 1343 (1954). Subsequently, in G.C.M. 26690, 1951-1 C.B. 28, the IRS ruled that such property was used in the taxpayer's trade or business. Under that ruling, the property was depreciable and, if it were sold at a gain, the income would be capital gain and, if sold at a loss, would be ordinary loss.

ment of section 595 (S. Rept. No. 1881, 87th Cong., 2d Sess. 47-48, 1962-3 C.B. 753-754, explains:

> Under existing law the foreclosure event is considered a taxable transaction. This has been interpreted to mean that a bad-debt deduction may or may not arise at that time, depending upon the relation of the bid price of the property to the amount of the loan outstanding. Where the foreclosed property is bid in for the amount of the loan a bad debt deduction may not be taken under present law; however, a gain or loss may result at the time of foreclosure if the fair market value of property foreclosed is different from the price at which it was bid in. When the property is subsequently sold by the mutual savings institution, it may realize a further gain or loss on such disposition. Whether the gains and losses at the time of foreclosure and at the time of ultimate disposition are capital or ordinary gains and losses *depends on the nature of the activities of the institution at each such time.*
>
> The bill seeks to avoid these *erratic results* by providing that in the future a foreclosure is not to be treated as a taxable event, and that amounts received by the mutual savings institution subsequent to the foreclosure are to be treated as payments on the indebtedness. This would be accomplished under the bill by treating the property received in a foreclosure (or other proceeding) as having the same characteristics as the debt for which it was security. Thus, for bad-debt (or loss) purposes the act of foreclosure will not create a taxable occasion; * * * [Emphasis added.]

The difference between the amount received and the original or previously reduced debt is to be treated as ordinary loss or income and is to be charged, or credited, as the case may be, against the reserve for losses on qualifying real property loans. Since petitioner's position would require a finding on the "nature of the activities" of the lending institution at the time of the sale, it would frustrate this declared purpose to avoid the "erratic results" of making each case depend on its individual facts. It would ignore the express provision of section 595(b) that "For purposes of sections 166 and 1221" such foreclosed property "shall be considered as property having the same characteristics as the indebtedness" it secured.

Moreover, petitioner in effect concedes that "amount realized" does not always mean gross sales proceeds. When the foreclosing lending institution under State law is accountable to the borrower for receipts and the borrower is accountable for expenses, petitioner concedes that selling and other expenses are not deductible but, instead, increase the savings and loan association's basis in the foreclosed property and ultimately are credited to the reserve for losses on qualified loans. Yet in most instances, unless the gain on the foreclosure exceeds the amount of the debt, the net amount ultimately received and applied on the borrower's debt is the same, whether or not the borrower and lender are separately accountable for specific expenses. In that event, the entire gain on the sale is applied on the debt. There is nothing in the language of section 593 or 595 or their legislative history even suggesting that Congress intended to make the issue as to whether selling expenses should be credited or charged to the reserve account or deducted under section 162(a) turn on State law.

To buttress this "accountability" argument, however, petitioner focuses on section 1.595-1(e)(7) and (8), Income Tax Regs. Petitioner interprets these regulations to allow a deduction for all post-foreclosure expenses, including selling commissions and expenses, where under State law the borrower in default is not accountable to the creditor for such expenditures. As we view those regulations, however, such an interpretation is erroneous.

The specific language relied on by petitioner is found in section 1.595-1(e)(7), Income Tax Regs., which in pertinent part provides as follows:

> Section 595 does not change the treatment of rents, royalties, dividends, interest, or similar amounts received or accrued by the creditor with respect to acquired property, nor does it change the treatment of expenses incurred with respect to such property.

Petitioner points to examples (1) and (2) of section 1.595-1(e)(8), Income Tax Regs.,[14] which explain

[14]Sec. 1.595-1(e)(8), Income Tax Regs., provides as follows:

(8) *Examples.* The provisions of subparagraphs (6) and (7) of this paragraph may be illustrated by the following examples:

Example (1)—(i) *Facts.* X Corporation, a creditor which is an organization described in section 593(a), uses the reserve method of accounting for bad debts. On May 1, 1964, X reduces to ownership or possession by agreement or process of law improved real property which is security for an indebtedness of A which is in default. On the date of acquisition there remains unpaid on the indebtedness $20,000 principal and $700 interest. X has previously included the $700 interest in gross income. Subsequent to acquisition, X incurs expenses totaling $500 for maintenance, and during the period June 1 through September 30, 1964, rents the property for a total rental of $400. Under local law, X is accountable to A for the rents received and A is accountable to X for the expenses incurred. There are no other receipts or expenses

the treatment to be accorded items of income received by, and expenses incurred by, a creditor during the interim period between the foreclosure and the sale of the property. Those examples, however, deal only with costs of maintaining property held by the creditor

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until October 1, 1964, at which time X sells the acquired property for $22,000. Under local law, A is not entitled to any portion of the sales proceeds.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,800
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,800)	1,200

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,200 portion of the sales proceeds would be treated as ordinary income.

Example (2)—(i) *Facts.* The facts are the same as in example (1) except that under local law X is not accountable to A for any portion of the rents received and A is not accountable to X for the expenses incurred by X.

(ii) *Treatment of rents and expenses.* X includes in gross income the total rent receipts of $400 and deducts (if otherwise allowable) the expenses of $500.

(iii) *Treatment of sales proceeds.* As the result of the sale of the acquired property, X credits $1,300 to the reserve for losses on qualifying real property loans, computed as follows:

Basis of acquired property at acquisition and at date of sale (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700

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while it is rented, and nothing in the language of the examples outlines the treatment of selling expenses and commissions. When viewing the language of section 1.595-1(e)(7), Income Tax Regs., and the examples outlined in section 1.595-1(e)(8), Income Tax Regs., the only logical premise which can be drawn is that items of income and expenses generated by income producing property must be allocated according to accountability for such items under State law.

Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,700
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,700)	1,300

(iv) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,300 portion of the sales proceeds would be treated as ordinary income.

Example (3)—(i) *Facts.* The facts are the same in example (1) except that X sells the acquired property for $15,000.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of $15,000 sales proceeds applied in reduction of adjusted basis of acquired property	15,000
Amount charged to reserve for losses on qualifying real property loans	5,800

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the excess of $5,800 would be allowed as a specific bad debt deduction.

They do not purport to deal with expenses incurred in selling the foreclosed property.

The only provisions in section 595 and its accompanying regulations, dealing with costs similar to those in issue, are found in section 595(c) and section 1.595-1(d), Income Tax Regs. Section 595(c) states that the basis of foreclosed property in the hands of the creditor shall be the basis of the secured indebtedness, properly increased for the cost of acquisition. Such costs of acquisition are described in section 1.595-1(d), Income Tax Regs., as follows:

> * * * expenditures incurred by the creditor (for example, fees for an attorney, master, trustee, auctioneer, for publication, acquiring title, clearing liens, filing and recording, and court costs) * * *

These costs of acquisition are virtually identical to the selling commissions and expenses here at issue, and in our view, it would be an unwarranted inconsistency to apply such costs on the acquisition of property to the reserve for losses on qualifying real property loans but to deduct under section 162(a) the same type of expenditures on the subsequent resale of the same property.

In summary, we conclude the following:

1. Commissions and other selling expenses[15] are not deductible under section 162 as ordinary and necessary expenses of petitioner's business.

[15]Indirect expenses, such as the salaries, office, and other related expenses of savings and loan association personnel handling foreclosures, are, of course, deductible under sec. 162(a). Those expenses are not related to any specific property and in no circumstances would be deductible under sec. 166 as additions to bad debt reserves.

2. Commissions and other selling expenses must be accounted for through appropriate charges or credits to petitioner's reserve for losses on qualifying real property loans as provided in section 595(b) and its supporting regulations.[16]

To reflect the foregoing,

Decision will be entered under Rule 155.

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[16]Attached to the petition is a copy of a technical advice memorandum dated Dec. 28, 1971, concluding the expenses here in issue are deductible under sec. 162(a) as well as a copy of a technical advice memorandum, dated Jan. 12, 1973, and Rev. Rul. 73-116, 1973-1 C.B. 300, reaching a contrary conclusion. The petition alleges respondent is estopped by the first of the two memoranda to deny the disputed deductions. Petitioner has not briefed its estoppel allegation and we treat it as abandoned. See *Automobile Club v. Commissioner*, 353 U.S. 180 (1957). In reaching the foregoing conclusion, we have proceeded on the principle that "Congress, not the Commissioner, prescribes the tax laws." *Dixon v. United States*, 381 U.S. 68, 73 (1965).

APPENDIX C.

Order.

United States Court of Appeals for the Ninth Circuit.

ALLSTATE SAVINGS & LOAN ASSOCIATION, Successor-in-Interest to Metropolitan Savings and Loan Association of Los Angeles, Petitioner-Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee. No. 77-3221.

Filed: Oct. 5, 1979.

Before: TRASK, GOODWIN and SNEED, Circuit Judges.

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for en banc rehearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for a rehearing en banc is rejected.

APPENDIX D.

I.R.C. Sec. 595.

FORECLOSURE ON PROPERTY SECURING LOANS

Sec. 595. (a) NONRECOGNITION OF GAIN OR LOSS AS A RESULT OF FORECLOSURE.—In the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

(b) CHARACTER OF PROPERTY.—For purposes of sections 166 and 1221, any property acquired in a transaction with respect to which gain or loss to an organization was not recognized by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. Any amount realized by such organization with respect to such property shall be treated for purposes of this chapter as a payment on account of such indebtedness, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to allowance of a deduction for bad debts) apply.

(c) BASIS.—The basis of any property to which subsection (a) applies shall be the basis of the indebtedness for which such property was secured (determined as of the date of the acquisition of such property), properly increased for costs of acquisition.

(d) REGULATORY AUTHORITY.—The Secretary shall prescribe such regulations as he may deem necessary to carry out the purposes of this section.

APPENDIX E.

Regulations.

§ 1.595-1. Treatment of foreclosed property by certain creditors.—(a) *Nonrecognition of gain or loss on the acquisition of security property by certain creditors*—(1) *In general.* Section 595(a) provides that in the case of a creditor which is an organization described in section 593(a) (that is, a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless for purposes of section 166 (relating to bad debts), as the result of a transaction by which such creditor bids in at foreclosure, or reduces to ownership or possession by agreement or process of law, any property (whether real or personal, tangible or intangible) which was security for the payment of any indebtedness (whether or not a qualifying real property loan as defined in section 593(e)(1)). The treatment provided by section 595(a) is mandatory (regardless of whether such creditor utilizes the specific deduction or reserve method of accounting for bad debts) if, for the taxable year in which the property is bid in at foreclosure, or reduced to ownership or possession by agreement or process of law, the creditor is an organization described in section 593(a), even though the creditor subsequently becomes an organization not described in section 593(a). For definition of the terms "domestic building and loan association" and "cooperative bank" for taxable years beginning after October 16, 1962, see paragraphs (19) and (32), respectively, of section 7701(a).

(2) *Effective date.* Section 595 applies to any transaction (described in subparagraph (1) of this paragraph) occurring after December 31, 1962, except that such section does not apply to any such transaction in which the taxable event determined without regard to section 595 (that is, the sale or exchange to the creditor of the security property by reason of the default or anticipated default of the debtor) occurred before January 1, 1963.

(b) *Rules for determining when security property is reduced to ownership or possession by agreement or process of law.*—(1) *Ownership or possession.* For purposes of this section, security property shall be considered as reduced to ownership or possession by agreement or process of law on the earliest date on which the creditor, by reason of the default or anticipated default of the debtor,—

(i) Acquires, by agreement or process of law, a title to, or a right or interest in, the security property which under local law is indefeasible and which the creditor can validly dispose of apart from the indebtedness which the property secures, or

(ii) Acquires, by agreement or process of law, an enforceable right to direct the use to which the security property shall be put, including, in the case of real property, whether or not the property shall continue to be occupied by the debtor who has defaulted (regardless of whether such creditor has obtained indefeasible title to the property), or

(iii) Sells or otherwise disposes of the security, property or any interest therein.

(2) *Agreement or process of law.* The reduction of security property to ownership or possession by agreement includes, where valid under local law, such

methods as voluntary conveyance from the debtor (including a conveyance directly to the Federal Housing Commissioner) and abandonment to the creditor. The reduction of security property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession by writ of entry, or by publication or notice.

(c) *Examples.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). On January 31, 1963, X, a creditor which is an organization described in section 593(a), purchases at a foreclosure sale residential real property which was security for a debt owing to X, and with respect to which the debtor has defaulted. Under local law, there is a 1-year statutory redemption period (during which period the debtor is entitled to remain in possession) so that X must wait until February 1, 1964, to obtain indefeasible title to the property. No gain or loss is recognized by reason of the purchase at the foreclosure sale on January 31, 1963. However, the date on which the security property is considered as reduced to ownership or possession by agreement or process of law is February 1, 1964. If, under local law, there were no statutory redemption period so that X obtained indefeasible title to the security property at the foreclosure sale, the date on which the security property would be considered as so reduced is January 31, 1963. Furthermore, with respect to

either of the preceding situations, if the foreclosure sale had occurred on November 1, 1962 (instead of on January 31, 1963), section 595 would not apply to the transaction since the taxable event in respect of such transaction occurred prior to January 1, 1963.

Example (2). The facts are the same as in example (1), except that instead of purchasing the property at a foreclosure sale, X, pursuant to the provisions of local law, enters upon the security property on January 31, 1963, and acquires an enforceable right to direct whether the property shall continue to be occupied by the debtor. X does not obtain indefeasible title to the property until February 1, 1964. The date on which the security property is considered as reduced to ownership or possession by agreement or process of law is January 31, 1963.

(d) *Basis of acquired property.* Section 595(c) provides that the basis of any property to which section 595(a) applies (hereinafter referred to as "acquired property") shall be the adjusted basis of the indebtedness for which such property was security, determined as of the date of acquisition of such property, properly increased for costs of acquisition. The date of acquisition is the date, determined under paragraph (b) of this section, on which the security property is reduced to ownership or possession by agreement or process of law. Costs of acquisition are expenditures incurred by the creditor (for example, fees for an attorney, master, trustee, auctioneer, for publication, acquiring title, clearing liens, filing and recording, and court costs) which are directly related to the foreclosure sale or proceeding, or to the other process used to reduce the security property to ownership or possession, or both, by agreement or process of law. For purposes

of determining the adjusted basis of the indebtedness for which the acquired property was security, there shall be included the amount of any unpaid interest with respect to such indebtedness, but only to the extent that it has been included in gross income. The basis of the acquired property, as determined under this paragraph, shall be adjusted in accordance with the rules provided in paragraph (e) of this section.

(e) *Characteristics of acquired property*—(1) *Depreciation; decline in fair market value.* Section 595(b) provides, in part, that for purposes of section 166 (relating to bad debts) acquired property shall be considered as property having the same characteristics as the indebtedness for which such property was security. Thus, no deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed to a creditor with respect to acquired property. However, if, at any time, the adjusted basis of the acquired property exceeds the fair market value of such property (determined by proper appraisal and without regard to any outstanding right of redemption), and the creditor can establish (in the same manner as worthlessness in whole or in part is established for purposes of section 166) that an amount equal to any portion of such excess will not be collected with respect to the indebtedness for which such property was security, the creditor may treat such portion, under the provisions of section 166, as a worthless debt. In such case, the basis of the acquired property shall be reduced by the amount treated as a worthless debt.

(2) *Example.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Corporation, a creditor which is an organization described in section 593(a), makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. In 1963, A defaults in his payments on a debt owed to X which is secured by residential real property. X reduces the property to ownership or possession by agreement or process of law by bidding it in at a foreclosure sale for $23,000. The adjusted basis of the indebtedness at the date of acquisition of the property (increased for costs of acquisition) is $25,000, and this amount becomes the basis of the acquired property. X obtains a deficiency judgment against A for $2,000. Later in 1963, a proper appraisal enables X to establish that the fair market value of the property is $18,000. X is also able to establish (under the rules of section 166 and the regulations thereunder) that due to A's poor financial condition only $1,000 can be collected on the outstanding deficiency judgment. For the year 1963, X can charge its bad debt reserve for $6,000, computed as follows:

Basis of acquired property	$25,000
Less: Fair market value of acquired property	18,000
Excess	$ 7,000
Less: Collectible portion of deficiency judgment	1,000
Portion of excess treated as worthless debt	$ 6,000

(3) *Capital improvements made after date of acquisition not treated as acquired property.* Except as provided in subparagraph (4) of this paragraph, the term "acquired property" does not include capital improvements made after the date of acquisition (within the meaning of paragraph (d) of this section) of the

property. Thus, the applicable deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed, if otherwise allowable, for improvements which are made by the creditor with respect to acquired property and which are properly chargeable to the capital account. If the creditor sells or otherwise disposes of the acquired property with such capital improvements, any amount realized by reason of such sale or other disposition shall be allocated in proportion to the respective fair market values of the acquired property and such capital improvements. The portion of the amount realized which is allocable to the acquired property shall be treated in accordance with the rules prescribed in subparagraph (6) of this paragraph. The portion of the amount realized which is allocable to such capital improvements shall be treated under the applicable rules governing the sale or other disposition of such property and without regard to section 595.

(4) *Treatment of minor capital improvements as acquired property.* A creditor may treat any minor capital improvements which it makes to a particular acquired property after the date of acquisition (within the meaning of paragraph (d) of this section) in the same manner as the acquired property, provided such creditor treats all minor capital improvements with respect to that particular acquired property in such manner. For purposes of section 595, a capital improvement shall be considered as "minor" only if the cost of such improvement does not exceed $3,000.

(5) *Records for capital improvements.* For purposes of subparagraphs (3) and (4) of this paragraph, the creditor must maintain such records as are necessary to clearly reflect, with respect to each particular acquired property, the cost of each capital improvement and whether the taxpayer treated minor capital improve-

ments with respect to such property in the same manner as the acquired property.

(6) *Amounts realized with respect to acquired property*. Section 595(b) provides, in part, that any amount realized with respect to acquired property shall be treated as a payment on account of the indebtedness for which such property was security, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to bad debts) apply. An amount realized with respect to acquired property means an amount representing a recovery of capital, such as proceeds from the sale or other disposition of the property, payments on the original indebtedness made by or on behalf of the debtor (including amounts received under an insurance contract with the Federal Housing Administration or a guarantee by the Veterans' Administration), and collections on a deficiency judgment obtained against the debtor (other than amounts treated as interest under applicable local law). Amounts realized with respect to acquired property include amounts which otherwise would be treated in the manner prescribed in section 351 (relating to transfer to a corporation controlled by transferor), section 354 (relating to exchanges of stock and securities in certain reorganizations), section 453 (relating to installment method), section 1031 (relating to exchange of property held for productive use or for investment), or section 1033 (relating to involuntary conversions). For purposes of section 595 (b), if a corporation distributes acquired property in a distribution to which section 311 (relating to taxability of corporation on distribution) or section 336 (relating to nonrecognition of gain or loss to a corporation on distribution of its property in partial or complete liquidation) applies, the fair market value of the acquired property at the time of the distribution shall be treated as an amount realized with respect to such property. However, no amount shall be considered realized by reason of the distribution or transfer of acquired property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, and in the case of such a distribution or transfer the acquired property shall be treated by the distributee or transferee as having the same characteristics as it had in the hands of the distributor or transferor at the time of such distribution or transfer. The following rules shall apply to amounts realized with respect to acquired property:

(i) Any amount realized shall be applied against and reduce the adjusted basis of the acquired property, and to the extent that such amount exceeds the adjusted basis, it shall, in the case of a creditor using the specific deduction method of accounting for bad debts, be included in gross income as ordinary income, or, in the case of a creditor using the reserve method of accounting for bad debts, be credited to the appropriate bad debt reserve (that is, the reserve for losses on qualifying real property loans or the reserve for losses on nonqualifying loans). Any amounts credited during the taxable year to a reserve for bad debts pursuant to this subdivision shall not be considered as a part of the addition under section 593 for such year, but shall be included in the balance of the reserve for purposes of computing such addition to the reserve for such taxable year. Thus, for example, an amount credited to the reserve for losses on qualifying real property loans during a taxable year shall not be considered as a part of the addition to such reserve computed under the percentage of taxable income method. However, the amount of such credit shall be included in

the balance of such reserve for the purpose of determining the amount necessary to increase the balance of such reserve (as of the close of such taxable year) to an amount equal to 3 percent of qualifying real property loans and for the purpose of determining whether such balance exceeds 6 percent of such loans.

(ii) If an amount realized on the sale or other disposition of the acquired property is insufficient to restore to the creditor the adjusted basis of the property, the difference between such adjusted basis and such amount realized shall be treated as a bad debt to which the provisions of section 166 apply. If the creditor subsequently realizes an additional amount with respect to the original indebtedness or the acquired property, such additional amount shall be treated as the recovery of a bad debt.

(7) *Treatment of rents, similar amounts, and expenses.* Section 595 does not change the treatment of rents, royalties, dividends, interest, or similar amounts received or accrued by the creditor with respect to acquired property, nor does it change the treatment of expenses incurred with respect to such property. (See, however, subparagraph (1) of this paragraph for treatment of depreciation, etc.) Thus, for example, if the acquired property is a governmental obligation within the meaning of section 103 (relating to interest on certain governmental obligations), interest payments received by the creditor with respect to such obligation would not be included in gross income.

(8) *Examples.* The provisions of subparagraphs (6) and (7) of this paragraph may be illustrated by the following examples:

Example (1)—(i) *Facts.* X Corporation, a creditor which is an organization described in section 593(a), uses the reserve method of accounting for bad debts.

On May 1, 1964, X reduces to ownership or possession by agreement or process of law improved real property which is security for an indebtedness of A which is in default. On the date of acquisition there remains unpaid on the indebtedness $20,000 principal and $700 interest. X has previously included the $700 interest in gross income. Subsequent to acquisition, X incurs expenses totaling $500 for maintenance, and during the period June 1 through September 30, 1964, rents the property for a total rental of $400. Under local law, X is accountable to A for the rents received and A is accountable to X for the expenses incurred. There are no other receipts or expenses until October 1, 1964, at which time X sells the acquired property for $22,000. Under local law, A is not entitled to any portion of the sales proceeds.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, *i.e.*, $20,000 principal plus $700 interest)		$20,700
Plus: Expenses charged to debtor		500
		$21,200
Less: Rents credited to debtor	$ 400	
Adjusted basis of acquired property at sale		$20,800
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,800	
	0	
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,800)		$ 1,200

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,200 portion of the sales proceeds would be treated as ordinary income.

Example (2)—(i) *Facts.* The facts are the same as in example (1) except that under local law X is not accountable to A for any portion of the rents received and A is not accountable to X for the expenses incurred by X.

(ii) *Treatment of rents and expenses.* X includes in gross income the total rent receipts of $400 and deducts (if otherwise allowable) the expenses of $500.

(iii) *Treatment of sales proceeds.* As the result of the sale of the acquired property, X credits $1,300 to the reserve for losses on qualifying real property loans, computed as follows:

Basis of acquired property at acquisition and at date of sale (adjusted basis of indebtedness, *i.e.*, $20,000 principal plus $700 interest)	$20,700
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,700
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,700)	$ 1,300

(iv) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,300 portion of the sales proceeds would be treated as ordinary income.

Example (3)—(i) *Facts.* The facts are the same as in example (1) except that X sells the acquired property for $15,000.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, *i.e.*, $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	$21,200
Less: Rents credited to debtor	$ 400
Adjusted basis of acquired property at sale	$20,800
Less: Portion of $15,000 sales proceeds applied in reduction of adjusted basis of acquired property	15,000
Amount charged to reserve for losses on qualifying real property loans	$ 5,800

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the excess of $5,800 would be allowed as a specific bad debt deduction. [Reg. § 1.595-1.]

APPENDIX F.

The Subject Technical Advice.

District Director
Los Angeles, California
National Office
Metropolitan Savings and Loan Association of Los Angeles

This is in reply to your request for technical advice dated July 13, 1971, as to whether certain commission expenses, incurred in the disposition of real properties acquired by foreclosure, should be treated as ordinary and necessary business expenses deductible under section 162 of the Internal Revenue Code of 1954 or whether such expenses should be used in the computation of the gain or loss charged to the bad debt reserve, pursuant to section 595 of the Code.

The facts, on the basis of which technical advice is requested, are as follows:

The Metropolitan Savings and Loan Association of Los Angeles (hereinafter taxpayer), is a savings and loan association as defined under section 7701(a)(19) of the Code, and is subject to the provisions set out in sections 593 and 595 of the Code. The taxpayer acquired certain real properties by foreclosure. Said properties were security for loans made by the taxpayer in the normal course of business which are considered "qualifying real property loans."

During the years 1968 and 1969, the taxpayer incurred certain expenses in selling the properties acquired through foreclosure pursuant to state law. The properties acquired by the taxpayer were sold through unrelated outside real estate brokers who charged the taxpayer

commissions for their services. On its Federal income tax returns, the taxpayer treated the commission expenses as ordinary and necessary business expenses, and deducted the sums of $242,034 in 1968, and $37,764 in 1969.

Section 595 of the Code provides that in the case of a creditor which is an organization described in section 593(a) of the Code, no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness. Such property is to be considered as having the same characteristics as the indebtedness for which such property was security. Any amount realized with respect to such property is to be treated as payment on account of such indebtedness and any loss with respect thereto is to be treated as a bad debt to which the provisions of section 166 of the Code apply. The basis for any such property is the basis of the indebtedness for which the property was secured (determined at the date of acquisition of such property), properly increased for costs of acquisition.

Section 1.595-1(d) of the regulations provides further guidelines for determining the adjusted basis of the acquired property. Under this paragraph, costs of acquisition are defined as expenditures incurred by the creditor which are directly related to the foreclosure sale or proceeding. Paragraph (e)(7) of the same section of the regulations states that section 595 of the Code does not change the treatment of expenses incurred with respect to acquired property.

The above-cited provisions of the Code and regulations provide that the adjusted basis of property acquired by foreclosure shall be determined at the time such property is acquired. The only exception to this determination is provided in example (1) of section 1.595-1(e)(8) of the regulations.

Relevant to section 1.595-1(e)(8) of the regulations and pertinent to resolving the issue in the instant case, is the local law where the transactions in question have taken place. If under local law, the debtor is accountable to the creditor acquiring property for expenses incurred in connection with the property, such expenses are includable in determining the adjusted basis of the property at time of sale. If, however, under local law the debtor is not accountable to the creditor for expenses incurred, example (2) of the same section of the regulations provides that the creditor deduct the expenses (if otherwise allowable) from its gross income.

According to law of the State of California, the local law, the taxpayer is not accountable to a debtor, and a debtor is not accountable to the taxpayer for rents or expenses incident to property securing indebtedness which the taxpayer acquires by foreclosure, in those instances where the property foreclosed is sold pursuant to a Power of Sale Foreclosure.

Based on the foregoing, we conclude that since, under local law, in those cases where the debtor is not accountable to the taxpayer for expenses incurred incident to the property securing indebtedness, and which the taxpayer acquired pursuant to a Power of Sale Foreclosure, the commission expenses incurred by the taxpayer incident to disposition of the properties

are not includable as adjustments to the basis of such properties.

In Revenue Ruling 57-468, C.B. 1957-2, 543, it was held that real estate acquired by a building and loan association in foreclosure was held primarily for sale to customers in the ordinary course of its trade or business. Section 162(a) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) of the regulations provides, in pertinent part, for a deduction from gross income for management expenses, commissions, advertising and other selling expenses directly connected with or pertaining to the taxpayer's trade or business.

Accordingly, it is our conclusion that the commission expenses of the taxpayer which are ordinary and necessary expenditures directly connected with or pertaining to the disposition of real properties acquired by foreclosure, described above, are allowable deductions from gross income under section 162 of the Code.

APPENDIX G.

The 1972 Technical Advice.

This is in reply to your request for technical advice dated December 8, 1971, as to whether certain expenses, incurred in maintaining acquired property that is not income producing, should be treated as ordinary and necessary business expenses deductible under section 162 of the Internal Revenue Code of 1954 or whether such expenses should be used in the computation of the gain or loss charged to the bad debt reserve, pursuant to section 595 of the Code.

The facts, on the basis of which technical advice is requested, are as follows:

The [name of savings and loan association] (hereinafter referred to as taxpayer), is a savings and loan association as defined under section 7701(a)(19) of the Code, and is subject to the provisions set out in sections 593 and 595 of the Code. The taxpayer uses the cash receipts and disbursements method of accounting and the reserve method of computing bad debts.

During the periods in question the taxpayer was the holder of various parcels of real estate, which had been acquired through the process of foreclosure, or by deed in lieu of foreclosure, after default by the borrowers. Incident to the ownership of these properties, taxpayer incurred various operating expenses. Included among these expenses were minor repairs, routine maintenance, insurance and real estate taxes. Many of the parcels of real estate were rented. There were, on the other hand, a substantial number of parcels which were not rented. Periods of occupancy of particular parcels were oftentimes followed by periods of vacancy and vice versa. On its Federal income

tax returns for 1968 and 1969 the taxpayer treated the expenses, incurred subsequent to foreclosure and not directly related thereto, as ordinary and necessary business expenses, and deducted the sums of $42,130.41 in 1968 and $95,929.33 in 1969.

Section 595 of the Code provides that in the case of a creditor which is an organization described in section 593(a) of the Code, no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness. Such property is to be considered as having the same characteristics as the indebtedness for which such property was security. Any amount realized with respect to such property is to be treated as payment on account of such indebtedness and any loss with respect thereto is to be treated as a bad debt to which the provisions of section 166 of the Code apply. The basis for any such property is the basis of the indebtedness for which the property was secured (determined at the date of acquisition of such property), properly increased for costs of acquisition.

Section 1.595-1(d) of the Regulations provides further guidelines for determining the adjusted basis of the acquired property. Under this paragraph, costs of acquisition are defined as expenditures incurred by the creditor which are directly related to the foreclosure sale or proceeding. Paragraph (e)(7) of the same section of the Regulations states that section 595 of the Code does not change the treatment of expenses incurred with respect to acquired property.

The above-cited provisions of the Code and Regulations provide that the adjusted basis of property acquired by foreclosure shall be determined at the time such property is acquired. The only exception to this determination is provided in example (1) of section 1.595-1(e)(8) of the Regulations.

Relevant to section 1.595-1(e)(8) of the Regulations and pertinent to resolving the issue in the instant case, is the local law where the transactions in question have taken place. If under local law, the debtor is accountable to the creditor acquiring property for expenses incurred in connection with the property, such expenses are includable in determining the adjusted basis of the property at the time of sale. If, however, under local law the debtor is not accountable to the creditor for expenses incurred, example (2) of the same section of the Regulations provides that the creditor may deduct the expenses (if otherwise allowable) from its gross income.

We are unable to find any provisions under the law of the State of Missouri, the local law, making a creditor accountable to a debtor, nor a debtor accountable to a creditor for rent or expenses incurred incident to property securing indebtedness which the creditor acquires by foreclosure.

Based on the foregoing, we conclude that since, under local law, the debtor is not accountable to the taxpayer for expenses incurred incident to the property securing indebtedness, which the taxpayer acquired by foreclosure, the expenses, incurred by the taxpayer in maintaining acquired property (whether or not income producing property), are not includable as adjustments to the basis of such properties.

In Revenue Ruling 57-468, C.B. 1957-2, 543, it was held that real estate, acquired by a building and loan association in foreclosure, was held primarily for sale to customers in the ordinary course of its trade or business. Section 162(a) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) of the Regulations provides, in pertinent part, for a deduction from gross income for management expenses, commissions, advertising and other selling expenses directly connected with or pertaining to the taxpayer's trade or business.

Accordingly, it is our conclusion that, in the instant case, the expenses incurred by the taxpayer in maintaining property acquired on foreclosure (whether or not such property is income producing) are ordinary and necessary expenditures directly connected with or pertaining to the disposition of real properties acquired by foreclosure. Consequently, these expenditures are allowable deductions from gross income under section 162 of the Code.

APPENDIX H.

Rev. Rul. 73-116.

Section 595. — Foreclosure on Property Securing Loans.

Advice has been requested as to the manner in which expenditures paid or incurred under the circumstances described below are to be treated for Federal income tax purposes.

The taxpayer is a domestic building and loan association as defined in section 7701(a)(19) of the Internal Revenue Code of 1954. Its business consists principally of acquiring the savings of the public and investing in loans as described in section 7701(a)(19)(B) of the Code. The taxpayer uses the reserve method of accounting for bad debts as allowed under section 166(c) of the Code. During 1971, the taxpayer bid in and acquired at foreclosure properties securing several of its qualifying real property loans upon which its debtors had defaulted. The taxpayer treated such foreclosures in the manner provided for in section 595 of the Code.

In 1972 the taxpayer sold several of the properties that it had acquired by foreclosure in order to recover on the loans. In connection with these sales, the taxpayer paid or incurred real estate commissions, advertising, and related selling expenses. These expenses reduced the amount the taxpayer received from the sales.

The question presented concerns the proper manner of treating the expenditures made by the taxpayer in selling the above described property.

Section 595(a) of the Code provides as follows:

> In the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

For purposes of section 166 of the Code, relating to deductions for bad debts, and section 1221 of the Code, which defines the term "capital asset," section 595(b) of the Code provides that any property acquired in a transaction with respect to which gain or loss to an organization described in section 593(a) of the Code was not recognized by reason of section 595 of the Code is considered as property having the same characteristics as the indebtedness for which such property was security. Any amount realized by such organization with respect to such property is treated as a payment on account of such indebtedness, and any loss with respect thereto is treated as a bad debt to which the provisions of section 166 of the Code apply.

The Senate Finance Committee report in discussing the reasons for the enactment of section 595 of the Code as part of the Revenue Act of 1962, P.L. 87-834, 1962-3 C.B. 111, provides, in part:

> When the property is ultimately sold or disposed of, the difference between any amount realized and the original or previously reduced debt, is to be treated as ordinary loss or income and is to be charged, or credited, as the case may be, against the reserve for losses on qualifying real property loans. * * * S. Rep. No. 1881, 87th Cong. 2d Sess., 47-48.

Further, the Senate report also states that the provisions of section 595 of the Code are intended to treat amounts received by institutions, such as the instant taxpayer, subsequent to the foreclosure as payments on the indebtedness.

Accordingly, pursuant to section 595 of the Code, the expenditures made by the taxpayer in selling or otherwise disposing of the properties that it had acquired by foreclosure are to be taken into account in computing the gains or losses resulting from the disposition of the foreclosed property and are not to be deducted as ordinary and necessary business expenses under section 162 of the Code. The gains and losses arising from such sales are to be reflected as credits and charges, as the case may be, to the taxpayer's reserve for losses on qualifying real property loans.

In Revenue Ruling 57-468, 1957-2 C.B. 543, it is held under the facts set forth therein, that real property acquired by a bank, mortgage finance company, building and loan association, or insurance company (other than a life insurance company) in foreclosure or by deeds in lieu of foreclosures is held primarily for sale to customers in the ordinary course of the trade or business, within the meaning of section

1221 of the Code, and, therefore, that gain or loss on the sale thereof constitutes ordinary gain or loss, rather than capital gain or loss. Revenue Ruling 57-468 is not applicable to taxpayers described in section 593 (a) of the Code for taxable years after the effective date of section 595 of the Code (i.e., taxable years beginning after December 31, 1962), which is the exclusive provision governing the Federal income tax consequences of foreclosures on mortgages by such organizations.